

\$50.00 ANNUALLY
40 Letters Per Year

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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Registered with the Securities and Exchange Commission

May 2, 1960

Number 102

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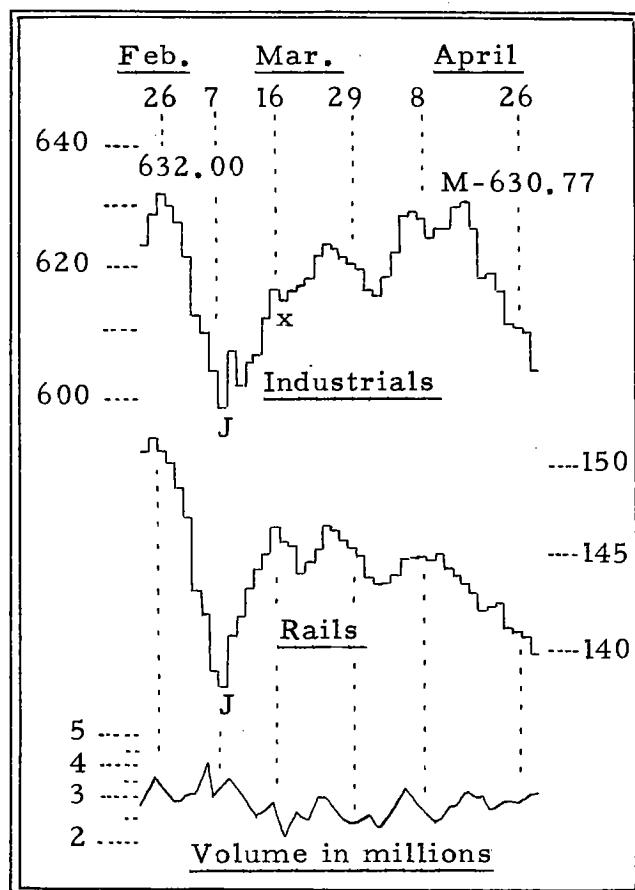
PRICE MOVEMENTS. Last week's market was one of those ominous affairs in which stocks are sold off against a continuous flow of favorable corporate statements. On April 25, Industrials followed the lead of the Rails by violating their previous decline low at x (on chart). This cracked the recent secondary structure and brought the two Averages within striking distance of the bear market lows at J.

A forthcoming joint penetration of the J lows (Industrials 599.10, Rails 138.18) would mean that the third leg of the bear market was under way. Remembering that the Averages act not on today's news but on what the best informed minds in the market anticipate for the future, an extension of the primary bear trend would suggest that corporate profits will take a decided turn for the worse in the period ahead.

If one or both Averages can hold above the J lows, and if the Averages then succeed in building a series of ascending zig-zags, the picture will take on a (temporarily) rosier hue. For the present, the minor and secondary trends are down. The great primary or tidal movement of the market turned down on July 8, 1959, and continues down. Today's stockholders are swimming against this tidal movement, an investment procedure roughly comparable to running up a down escalator.

THE MARKET. In the Letter of March 15, I discussed the psychology which prevails during bear swings. In general, bear market reactions (rallies) end amid temporary bursts of hopeful news. At the peak of a bear market rally, traders seem to regain some of their former bullishness, and one is apt to hear talk of "a new bull market". Conversely, bear market declines terminate amid unpleasant financial headlines and excessive pessimism. The headlines and the pessimism, however, have usually been thoroughly discounted by the market on the downward swing. Thus, amateur selling at the bottom creates a "sold-out" market and prepares the way for the next rally.

If we go back a few months, we can remember that the January-March, 1960, decline occurred amid glowing economic reports and predictions. Near the March 8 lows an "unexpected" spate of bad news was released and the market rallied. At the top of the rally (April) the automobile and retail news turned brighter, but the market had already discounted this in the rise. The most recent decline took place against the bullish pronouncements of Secretary Anderson, clearing weather conditions and a further pick-up in auto and retail sales. A joint violation of the bear



market lows at J would suggest a new batch of bad news this summer, perhaps worse news than any that has so far graced the nation's financial pages.

MARKET COMMENTS. I have written a good deal about those periods in which the two Averages do not "agree" as to direction. It is a reasonable practice in areas of non-confirmation or divergence to give precedence to the primary direction. Thus, after a rally in a bear market, when one Average refuses to confirm the other on the upside, the strong presumption is that the next direction of the market will be down. More positive proof is provided if the two Averages then retreat below previous minor decline lows. The converse of this is true in a bull market, and many impressive advances have been "tipped-off" in areas where one Average refused to follow (confirm) the other through an important low point.

On the recent advance which took Industrials to M (see chart), the failure of Rails to confirm taken together with the primary bear trend suggested that the next direction would be down. Further indications were provided when both Averages violated their previous decline lows. In such areas shorts may be put out with the provision that those shorts be covered if a subsequent advance succeeds in taking both Averages above the preceding minor peaks.

Although many readers of these Letters have been short sellers and some have already established gratifying paper profits, I want to emphasize again that the great profits in the market are usually made by buying early in a bull market, not by selling short in a bear market. Aside from psychological considerations, a ten thousand dollar investment on the short side cannot possibly net the short seller any more than the total amount of his investment (in this case ten thousand dollars). In other words the gains, assuming even that the shorting has been of the most informed variety and that the stocks go to zero, are necessarily limited. The same ten thousand invested early in a bull market can obviously net the buyer a much greater amount, since (1) there is no theoretical ceiling on the price to which a stock can advance in a bull market, (2) bull markets tend to last longer than bear markets, (3) dividends are collected by stockholders and paid out by short sellers, and (4) capital gains are allowed on the long side but not on the short side.

This is not an attempt to discourage the would-be short seller, but it is a warning to the effect that short operations should be conservative and undertaken with the full realization that a short sale is always a speculation -- never an investment.

GRAVITY. Many investors entertain the mistaken notion that in the absence of buying, stocks will simply hold at given levels until buying returns. Unfortunately, such is not the case. There is a normal tendency for stocks to fall of their own weight, and it takes steady buying to hold (much less advance) stock prices. Each stock on the Exchange has a "bid-and-asked" quotation, with the "asked" price, of course, always higher than the "bid." In an advancing market the "asked" prices are taken, and as the floating supply of stock is absorbed at each successive price level, the "asked" prices are raised and the market works higher. But in an indifferent market the "bid" prices are "hit", and since buyers are always trying to purchase stocks below the market, a continual hitting of the "bids" results in declining prices. In other words, prices normally fall of their own weight as "bids" are accepted, unless an active demand arrives which results in the "asked" prices being taken. In a bear swing, buying (bidding) usually drops off first. As prices retreat, stockholders' fears are aroused, and then selling increases as the lowering "bids" are hurriedly accepted.

The tendency of volume during a bear market swing is often deceptive, and it is usual to see prices erode first on diminishing volume; then, as previous decline lows are jointly violated, volume (selling pressure) increases. Following the peak of a bear market rally, it is the exception rather than the rule for the initial "turn-down" to be accompanied by

expanding volume. This deceptive phenomenon prevents bearishness from increasing too quickly during the early stages of a decline.

QUESTION. I have read that stocks seldom retreat very far in an election year. Is this true?

ANSWER. I have checked every presidential year against the history of the Averages and can find no basis for stating that any bull or bear market has been fundamentally affected by a forthcoming election. A bear market was on in 1920, and stocks collapsed in the face of Harding's (Republican) election that year. A bull market was in force in July, 1932, and stocks advanced in the four months prior to Roosevelt's election in November. Stocks had hit bottom on July 8, 1932, and in my opinion the subsequent bull market would have occurred if a giraffe had been elected in November, 1932. The same can be said of 1920.

It is ironic to note that in March, 1900, the exact reverse of the current election year fallacy was held to be true. Dow, in fact, wrote the following editorial to refute the prevailing misconception. "There appears to be some belief that the stock market never advances much in a Presidential year. This is a fallacy which should not last. The market moves in cycles. When a Presidential year comes in a period of rising, market prices go up. When it comes in a period of falling, market prices go down, whoever may be chosen chief magistrate. For instance, rising prices prevailed in the Presidential years of 1872, 1880 and 1888. Falling prices were the rule in 1884, 1892 and in 1896 down to the Presidential nominations, after which the market turned. Presidential years have affected trading when there has been a vital issue like that of a radical change in tariff or in currency at stake. A scare of some kind not infrequently comes during a Presidential canvass."

DOW ON THE TURN. Of the many principles discovered or formulated by Charles H. Dow, perhaps the least understood is the concept of the tidal movement, its reversal and the psychology which accompanies such a reversal. Because so many people know the name "Dow", and because so few have ever read what Dow actually wrote, I try to include quotations from this famous newspaper editor whenever the occasion warrants.

On the timing of a primary turn, Dow noted that a reversal takes time "because millions of people have to experience in their own fortunes the change of conditions before they are willing to accept them as genuine."

The momentum principle is discussed by Dow as he writes, "There is a general similarity in all 'booms' and in all periods of depression. The character of these movements is like a snowball running down an inclined plane and gathering snow as it runs. The movement is slow at the start, becoming quicker as progress is made and usually quickest of all just before it ends."

Nine days earlier, on May 3, 1900, Dow had written, "The wheel has turned round, but the wheel never stops, and after the circumference reaches the highest point it begins to turn down."

An insight into the public's psychology is provided in the next paragraph, written October 28, 1899: "If you ask the average man who trades in the stock market for a reason why he purchases a specific stock, he tells you 'by instinct'. He is perfectly familiar with the conditions which underlie the market, and as he sees quotations advance, he feels that he will be distinctly out of the running if he does not buy something. This 'instinct' is nothing more or less than an abiding faith in the lasting prosperity in nearly all lines of business."

FROM OLDE LONDON TOWNE. On January 4, 1960, the London Financial Times' Stock Index touched a high of 342.9. A reaction followed which took the Index back to 306.1 on March 9, 1960. Another advance got underway, but it fizzled on April 4 at 331.2 (see Letter 99), and this meant that the retracement had stopped 11.7 points short of bettering the January high. Last week (April 25) the 306.1 reaction low was shattered, and this would suggest that London is now in a bear market. World markets, as a study of history shows, tend to follow a single primary trend.

CANADA. The Rosar Indexes of Canadian Stock Prices (below) is further verification of this same thesis. Canada seems to be about two months ahead of us and England about a month behind.

SHORTS OR PUTS. The following stocks look weak. An M in parentheses means sell at the market, a number in parentheses signifies sell at or below that figure on a closing basis. Standard Packaging (M), National Acme (48)^{3/4}, Yale & Towne (29)^{3/4}, Calumet & Hecla (M), Howe Sound (M)^{1/2}, Ashland Oil (19)^{3/4}, Std. of Indiana (38)^{3/4}, Texaco (69)^{3/4}, Mead Corp. (M), Kansas City Southern (M)^{7/8}, Louisville Nashville (67)^{3/4}, West. Maryland (M)^{3/4}, Allied Chem. (48), Armco (58)^{1/4}, Carpenter Steel (39)^{3/4}, National Steel (M)^{1/4}, Youngstown S. & T. (M), Celanese (24)^{3/4}, Freuhauf (24), Elect. Auto Lite (44)^{3/4}, Gabriel (M), Bridgeport Brass (M)^{3/4}, Revere Copper (M). ^{1/2}

The International Oils continue to look very poor on the charts, and one wonders what the market sees ahead for these former investment favorites. According to my friend, Eliot Janeway (one of the few economists in the country who has been right on this market), the future oil trouble is coming from Russia! But regardless of where the trouble is coming from, the huge distribution patterns in Standard of California, Mission Corp., Getty, Socony, Standard of Jersey, Standard of Indiana, etc., suggests that something big is coming up. California, for instance, has cracked its 1956-57 lows, and although the stock "looks" historically "cheap", I would not want to own a share of it.

Headlines from this week's Business Week Magazine... "THE SAG IS REAL -- BUT TEMPORARY". Comment - every bear market is "real", and it all depends on your definition of "temporary".

(Written Sunday, May 1st - 8 A.M.)

Thirty Stocks Used in Dow Jones Industrial Averages are:

Allied Chemical	General Electric	Sears Roebuck
Aluminum Co.	General Foods	Std Oil of Cal.
Amer Can	General Motors	Std Oil of N. J.
Amer Tel & Tel	Goodyear	Swift & Co.
Am Tobacco	Inter Harvester	Texaco Inc.
Anaconda Co.	Inter Nickel	Union Carbide
Bethlehem Steel	Inter Paper	United Aircraft
Chrysler	Johns Manville	U. S. Steel
Du Pont	Owens-Ill. Glass	Westinghouse El
Eastman Kodak	Procter & Gamble	Woolworth

Twenty Railroad Stocks Used are:

Atchafalpa	Erie	NY NH & H
Atl Coast Line	Great North Ry	Norfolk & West'n
Baltimore & Ohio	Illinois Central	Pennsylvania
Canadian Pacific	Kansas City So	Southern Pacific
Che & Ohio	Louisv & Nash	Southern Railway
Chi Rk Is & Pac	N. Y. Central	Union Pacific
Del & Hudson	N. Y. C. & St. L.	

